FOMC Briefing
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A principal issue for the Committee in choosing monetary targets for 1985 is to decide how to weigh the need for enough monetary growth to encourage satisfactory economic expansion, with unemployment still relatively high, against the need to keep enough restraint on monetary growth to foster further progress toward reasonable price stability and to be perceived to be doing so by continuing gradually to lower monetary growth ranges. If a continued 4 percent rate of inflation is deemed satisfactory for 1985, there may not be much of a dilemma. But should the Committee wish to make further progress in 1985, then there may be a greater dilemma, given what we now take to be the underlying rate of inflation, since that may risk leading to real growth below, say, the upper part of a 3 to 4 percent range.

The growth ranges presented in alternative II might be construed as representing something of a compromise in these respects. They are, with the exception of credit, the same growth ranges adopted tentatively last summer--which contemplate reductions for M1 and M2 but not for M3 and credit. They are also relatively tight ranges in the sense that they leave little, if any, scope for realization of upward price pressures significantly greater than 4 percent, given real economic growth in the 3 to 4 percent area. This assumes, as noted in the blue book, that the trend rate of rise in the velocity of M1 is 1 to 2 percent, abstracting from the impact of interest rate movements. Such a trend rate presumes that velocity growth will be held a little under post world war II experience because deregulation will lead to a lower rate of financial innovation in the future. If that analysis and estimate of the trend are correct--a big if, of course, given the still limited experience with deregulation and the new checking and closely related accounts--then the odds are that M1 growth this year will be in the upper part of the 4 to 7 percent range given under alternative II.

We believe that growth of M2 and M3 will also be close to the upper limits of their respective alternative II ranges, as noted in the blue book. With respect to credit, the tentative range adopted in midsummer does not seem attainable, except perhaps barely so if there is no unusual amount of credit at all raised for mergers and related activity this year. Thus, a higher credit range seems technically more consistent with the monetary aggregates. However, adoption of such a range does have the disadvantage of possibly signalling greater willingness by the Federal Reserve to accommodate to a still expansive federal deficit. If the range is left the same rather than raised, perhaps some mention should be made at least in the policy record that the range assumes no unusual credit expansion related to such transactions as mergers and share redemptions.

The probability that the monetary aggregates under alternative II will run in the upper part, or close to the upper limits, of their ranges suggests that stronger inflationary pressures, or real demands for goods and services, than projected or expected would need to be rather promptly reflected in upward adjustments of interest rates. Indeed, the staff projection itself may entail some rise of interest rates from current levels, particularly if M2 and M3 are to be kept within alternative II ranges for the year but also perhaps consistent with projected M1 growth.

The suggested growth ranges of alternative I would be an approach to targeting for 1985 that provides more leeway on the upside of the ranges. It has certain advantages as compared with alternative II. First, it would provide allowance should trend velocity for M1 be even lower than, or on the low side, of a 1-2 percent per year range. Second, there would be scope to let the Ms run strong should demand for goods and services be weaker than currently anticipated at present levels of interest rates and exchange rates, or should inflationary pressures be significantly less than now expected. Under those conditions, the lower interest rates that would be required to keep the economy growing at a reasonable pace might also be associated with a significant strengthening in demands for monetary assets. Third, as a mere technical matter, it would simply make the midpoints of the ranges closer to the most likely outcome.

The alternative has important disadvantages, however. First, retaining the 1984 M1 and M2 ranges, and raising those for M3 and credit, as is proposed, might be taken as signalling a lessening of will on the part of the Fed in keeping inflation curbed. Such an interpretation is more likely under current circumstances, when fiscal policy for the year 1985 is likely to be more expansive than in 1984 and when the economy does not seem especially weak. It may also serve to reinforce a view that the 4 percent rate of inflation of the past two years is an irreducible minimum, perhaps, to be followed by an upward adjustment to a higher rate. Second, the ranges for alternative I, by providing more leeway than alternative II, may delay an interest rate response in short-term markets that may be needed, at least temporarily, should demand pressures strengthen more than now expected with the potential for leading to a sustained acceleration of prices.

Alternative III, which contemplates lower growth ranges than alternative II and tilts toward an actual lowering of M1 growth in 1985 relative to 1984, may well seem to be reaching a bit at this point. But something like it would need to be contemplated sooner or later if the Committee is to signal an intention to encourage a further reduction in the rate of inflation. Its main disadvantage, in my view, would be that it is probably premature. Its main advantage is that it would more firmly work toward a further abatement of inflationary expectations at the risk, however, of retarding real growth perhaps unduly in 1985 but with the potential of more sustained growth in subsequent years.

A final point if I may, Mr. Chairman. Should the Committee adopt monetary growth ranges in the expectation that the outcome may be in the upper part of them, it may wish to consider indicating that to the public. Such a phrase is suggested for M1 in the proposed directive language--indicating that growth in the upper part of the range is acceptable because of growth below the midpoint in the year just past. That may be a useful way of signalling an intention, but it does not necessarily convey the crucial economic reasoning. It has the disadvantage of making it seem that so-called "base drift" is necessarily undesirable, when in practice whether it is or not depends on assessment of the changes that may be occurring in demand for money relative to GNP, the psychological state of the public, and how M1 is to be assessed relative to other monetary aggregates and domestic credit and exchange market conditions. It might be more economically pertinent to suggest M1 growth in the upper part of the range would be acceptable in view of the potential for relatively slow growth in velocity and so long as inflationary pressures remain subdued.